

## **Focus Note No. 7, March 1997**

### **Effective Governance for Micro-finance Institutions**

The process of establishing micro-finance as a new industry mirrors the emergence of any entrepreneurial industry. The infant micro-finance industry has achieved a degree of success, and now it must institutionalize that success. This raises challenges that are common to all small businesses as they expand: issues of power, control, and transparency, as well as problems of cash flow, a perceived lack of legitimacy and a short track record. Since these challenges are faced by emerging industries all over the world, it is useful to review the typical pattern as industries mature.

A closer examination of governance includes an outline of the roles of the board members, board composition, and an explanation of important issues of trust and conflicts of interests. This section then explores governance issues in the particular case of micro-finance.

#### **Visionaries and Managers**

In emerging industries, the person who starts the company is often a visionary. In the case of micro-finance, the visionary is the person with the noble idea of lending US\$100 here and US\$200 there, mostly to women, and trusting that they will repay the loan. The visionary who starts a business with a fresh idea -- to make something better or less expensively, to make it in a new way or to satisfy a unique need -- is usually not interested in making money. The visionary wants to do something that no one else has done because it is interesting and exciting, and because it is worthwhile for society. Only after the business experiences some success, does the visionary reach the conclusion that they need to make a profit to pay salaries or to attract investors to expand the business.

At this stage, the infant business experiences its first set of challenges:

- How does the visionary entrepreneur transfer the skills and the inspiration that made the little enterprise a success into something larger?
- How does the business deal with cash flow constraints?
- How does it obtain the legitimacy necessary to enable it to borrow?

Often, the visionary is not interested in these issues. Visionaries are notoriously poor at supervising staff, negotiating with investors, or training successors. The business now needs a professional manager with a new set of skills to manage and sustain growth, that are distinct from the skills necessary to start an enterprise and promote a vision.

A professional manager is brought on board and the adolescent enterprise continues to do well, but the business culture begins to change. The manager creates structure, policies and procedures, and emphasizes the bottom line. Then the business reaches the next challenge: the maturing enterprise now requires governance to create checks and balances to

ensure that the manager does not become too powerful.

## Governance

Businesses in emerging industries go through these three stages characterized by vision, management, and governance. Upon developing into an institutionalized company with appropriate governance structures, the business encounters a new set of challenges that are common to all industries:

- How does the business preserve its vision?
- How does it balance growth, risk, and profitability?
- How does it establish a governance system that holds management accountable without undermining its independence and flexibility?

Governance is a system of checks and balances whereby a board is established to manage the managers. Governance is sometimes conceived as a virtuous circle that links the shareholder to the board, to the management, to the staff, to the customer, and to the community at large. Boards review, confirm, and approve the plans and performance of the senior management, but they do not usually provide vision. The board needs to know what the vision is, and then ensure that it is maintained. Management, on the other hand, is involved in the daily operations of putting the vision into action.

How does ownership affect governance? It is important not to confuse control with ownership. A company is a separate legal entity, which no one actually owns. Shareholders do not own a company, they own shares. They have a residual claim to the assets of the company if there is anything left after it has discharged all its obligations. Shareholders have the right to vote their shares to elect board members, who in turn control the company. It is not necessary for board members to be shareholders. In fact, it may be preferable if some of the members are independent and do not represent an investment in the company.

## Board Responsibilities

The basic responsibilities of the board comprise four specific roles: fiduciary, strategic, supervisory and management development.

1. **Fiduciary:** The board has the responsibility to safeguard the interests of all the institution's stakeholders. As such, the board serves as a check and balance to provide confidence to the company's investors, staff, customers, and other key stakeholders that the managers will operate in the best interests of the institution.
2. **Strategic:** The board participates in the organization's long-term strategy by critically considering the principal risks to which the organization is exposed, and approving plans presented by the management. The board does not generate corporate strategy, but instead reviews management's business plans in light of the institution's mission, and approves them accordingly.
3. **Supervisory:** The board delegates the authority for operations to the management through the Chief Executive Officer. The board supervises management in the execution of the approved strategic plan and evaluates the performance of management in the context of the goals and time frame outlined in the plan.
4. **Management Development:** The board supervises the selection, evaluation and compensation of the senior management team. This includes succession planning for the CEO. In the transition from a small, growing entrepreneurial organization to becoming an established institution, governance ensures that the company survives. Governance moves an institution beyond dependency on the visionary.

## **Board Composition**

The board should consist of members who have a diversity of skills, including financial, legal and managerial expertise, to give effective guidance to senior management and to critically analyze management's plans and reports. There is no magic formula for board composition. The selection criteria should arise from decisions about the role of the board and how it will carry out its role. For this purpose, a board must define the following items:

- The role of board members in external relations, such as building key alliances
- The existence of committees to oversee key areas of operations
- Term limits for board seats
- The process for replacing board members
- The role of the CEO in selecting board members
- The optimum number of board members
- Mechanisms to evaluate the contribution of individual members

Once the role of the board is determined, then it is possible to fill in the gaps of the existing composition. If board members represent particular constituencies, they may be unable to act as a member of the board in the interests of the institution, but instead will be apologists for other interests. This highlights the importance of independent board members who are chosen for their qualities of excellence. Since they do not have a financial stake or represent a specific constituency, they can be purely responsible to the interests of the corporation.

## **Trust and Conflicts of Interest**

The governance procedures and the actions of the board members should be such that they create accountability and enable the stakeholders to trust one another. Governance gives shareholders confidence that managers are being supervised. It creates checks to prevent management from serving its own interests. Governance engenders trust that allows a financial institution to attract depositors and investors. Governance provides assurance to government officials and, in the case of financial institutions, to bank superintendents.

One way to create trust in the governance process is to eliminate conflicts of interest. Board members should not receive any personal or material gain other than the approved remuneration. The board must have common and clear objectives. It is important that board members do not have political agendas that could influence the direction of the organization.

## **Governance, Micro-finance, and Transformation**

In the emerging micro-finance industry, micro-finance institutions (MFIs) have large pools of financial assets. In most MFIs, however, no one in the institution, either at the board or management level, has a financial stake in the institution. One of the rationales for changing institutional forms, from an NGO into a regulated financial intermediary, is that for-profit institutions have capital that is owned by someone who will be upset if their capital is dissipated. Once the institution has shareholders who have something to lose, then there are clear lines of accountability between the owners and the board members.

Many organizations in the micro-finance industry are struggling with the governance challenges of becoming for-profit institutions. The motivation of members on NGO boards is very different from members of traditional for-profit boards. When institutions begin as NGOs, board members usually have some allegiance to the visionary who assembled the board. They

participate on the board, not because they are interested in monetary gain, but because it enhances their ability, credibility, and prestige. Private sector representatives may join the board because they feel a strong social responsibility to the target market and a need to give something back to society. NGO board members do not usually fulfill the board's fiduciary role by assuming responsibility for the institution's financial resources, especially those provided by donors.

When NGOs transform into financial intermediaries, their boards need to assume new legal responsibilities. Do board members have the skills necessary to govern a more sophisticated financial institution? Do board members understand the objectives of a transformed micro-finance institution that combines a social mission with profitability? Board members tend to be persuaded by one objective or the other, but they seldom appreciate the balance between the two and the hybrid culture that management has to instill in the institution. Since individual members may not represent both objectives, the overall composition of the board should generate creative tension by striking a balance between these two perspectives.

In some cases, the main shareholder of the transformed institution is the parent organization. As a result, the primary influence on the board comes from an NGO that projects the governance approach of not-for-profits onto the new institution. While this presents an opportunity to build the NGO's social mission into the governance process, the relationship between the MFI and the NGO needs to be kept at arm's length, and include transparency and clear transfer pricing. An unfortunate example of the pitfalls of this relationship is the Corposol/Finansol crisis.<sup>1</sup>

When NGOs transform into for-profit financial institutions, they attract investors with different types of motivations and expectations of rewards. There are special equity funds, like Gateway Fund and Profund, that create a mechanism for investors to have representation on a board.<sup>2</sup> There are commercial investors who want to maximize the return on their investment. There are support institutions, like ACCION and Calmeadow, who bring technical expertise to the board, and who are interested in ensuring that the institution is true to its mission. There are multilateral investors, like the Multilateral Investment Facility of the InterAmerican Development Bank and the International Finance Corporation; there are donors who do not have the mechanisms to be proper investors; and there are private individuals who represent important local interests. Most investors want to have a guaranteed seat on the board. The governance challenge for micro-finance institutions is to juggle these varying motivations and expectations.

Board composition for MFIs is further complicated by the geographic locus of ownership vis-à-vis the operations. Funding often comes from investors that may be thousands of miles from the institution. Statutes may require boards to meet on a monthly basis, but it is not realistic for foreign board members to meet so regularly. This can lead to a situation where the control of the board becomes localized in the community where the institution is based, even though the local board members may have a very small stake in the institution.

### **Next Steps**

This review of governance and micro-finance raises more questions than it answers. Indeed, there are no easy answers, particularly in an infant industry that has yet to establish governance guidelines. Future steps on this topic could include: developing a recruiting kit to assist a board in identifying its role and the skills necessary for an MFI board; training board members about the hybrid objectives of micro-finance; preparing guidelines about the appropriate role of board members to avoid conflicts of interest; and conducting research to suggest ways of aligning incentives and compensation for senior management and board members with the social

objective of the institution.

<sup>1</sup>For a discussion on this subject, see *Corposol/Finansol: An Institutional Crisis in Micro-finance*, by Maria Eugenia Inglesias and Carlos Castello in *Establishing a Micro-finance Industry*, edited by Craig Churchill, Micro-Finance Network, 1997.

<sup>2</sup>The Gateway Fund is an equity investment vehicle which enables ACCION International to mobilize commercial investments for its affiliates. Profund is a for-profit investment fund providing equity and quasi-equity to commercial, financial intermediaries in Latin America that specialize in providing financial services to small and micro-entrepreneurs.

This paper is a reprint of, "Effective Governance for Micro-finance Institutions," by Max Clarkson and Michael Deck, Clarkson Center for Business Ethics, Faculty of Management, University of Toronto, Canada. It was presented at the Micro-Finance Network Annual Meeting in October 1996 and published in *Establishing a Micro-finance Industry*, edited by Craig Churchill, Micro-Finance Network, 1997. The original paper can be obtained from the Micro-Finance Network at 733 15th Street NW, Suite 700, Washington DC 20005; telephone (202) 347-2953; fax (202) 393-5115.